Audit's NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

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FIRMING SHORT-TERM MONEY RATES POSE TEMPORARY REIT PROFIT SQUEEZE

The rebound in Treasury bills rates from the February lows of nearly 3% to 3.8% in mid-March probably marks the bottoming of short-term rates. This thesis appears to be confirmed by hikes in the prime rate and Federal funds. The short-range impact on mortgage trusts is obvious. While trusts work on spreads, their commercial paper costs rise immediately while portfolio returns lag, especially when not tied to prime. This has prompted some mutual fund selling in recent weeks. On average, however, the impact has not been too noticeable on trust share prices. The response has varied among trusts. *C.I. Mortgage* went to shorter term paper and kept its March short-term money costs equal to February. *North American Mortgage* along with a couple of long-term trusts (see p.8 inside) have gone to intermediate-term straight debt to insulate themselves from a possible long-term rising cycle. This type of deal, by the way, reflects judicious use of warrants (at market well over book) permitting low coupons. The warrants account for a good part of the package value and the low coupon debenture is valued at substantial discount from par providing a good yield to maturity.

AUDIT INVESTMENT RESEARCH will have a booth at the Institutional Investor's Conference April 17, 18 and 19 at the New York Hilton. We welcome all subscribers who attend to visit us.

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HUD STUDY OF CONSTRUCTION LENDING SUGGESTS LENDERS ARE REDUCING COMMITMENTS

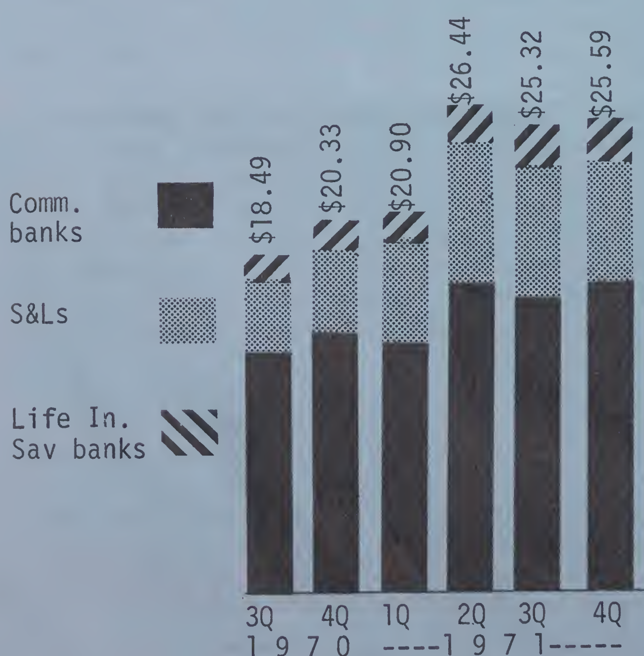
Analysis of the first year's data from the Housing and Urban Development Dept. study of construction lending suggests that major lenders began letting commitments run off after the middle of 1971. This conclusion, however, must remain highly tentative since the HUD study during 1971 did not cover construction lending by either mortgage bankers or real estate trusts. REITs will be included for 1972.

HUD began its monthly survey of construction lending a year ago as part of a major analysis of gross mortgage flows. Since about half of REIT assets apparently are committed to short-term construction and land development lending, the industry data holds major implications for REITs. We have refrained from any analysis until now so that a full year's experience with the data would be available for inspection.

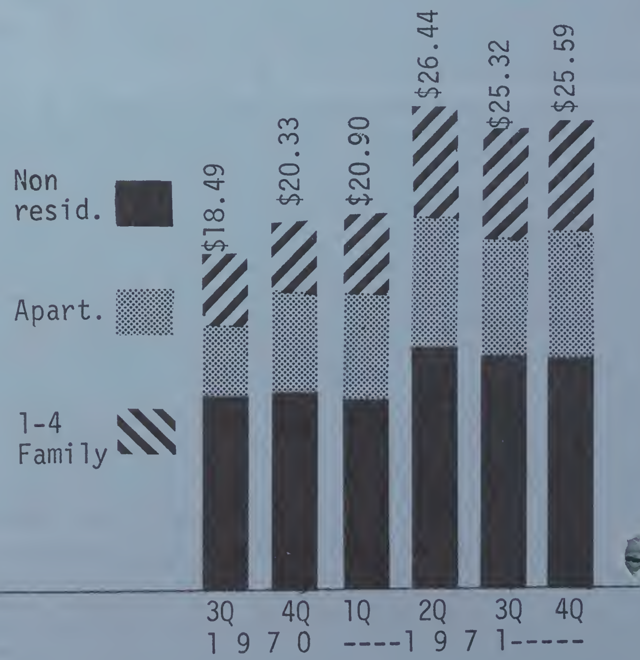
The monthly series shows that commitments for construction loans peaked at $26.44 billion last June and thereafter began a slow decline, ending the year at $25.59 billion. That's a decline of about $855 million, or only about 3.2% which may not be significant and could easily be reversed by data on the first quarter of 1972. But outstanding commitments by commercial banks peaked at $17.3 billion in May 1971. Savings banks and savings and loan associations both crested in July, and life insurance companies in August.

One other indication that lenders are letting construction commitments run off is the declining ratio of outstanding commitments to loans held. Graph III shows clearly that construction loan holdings (which are reported only at the end of each quarter) have continued to climb through the second half of 1971 even though outstanding commitments held on a high plateau. As a result the ratio of outstanding commitments to loans held began declining from its peak of 1.11, reached in the middle of 1971, to 0.94 at year end. A rising ratio indicates that lender commitments are out-

GRAPH I
OUTSTANDING CONSTRUCTION LOAN
COMMITMENTS - BY LENDER
(Quarterly - Billion $)

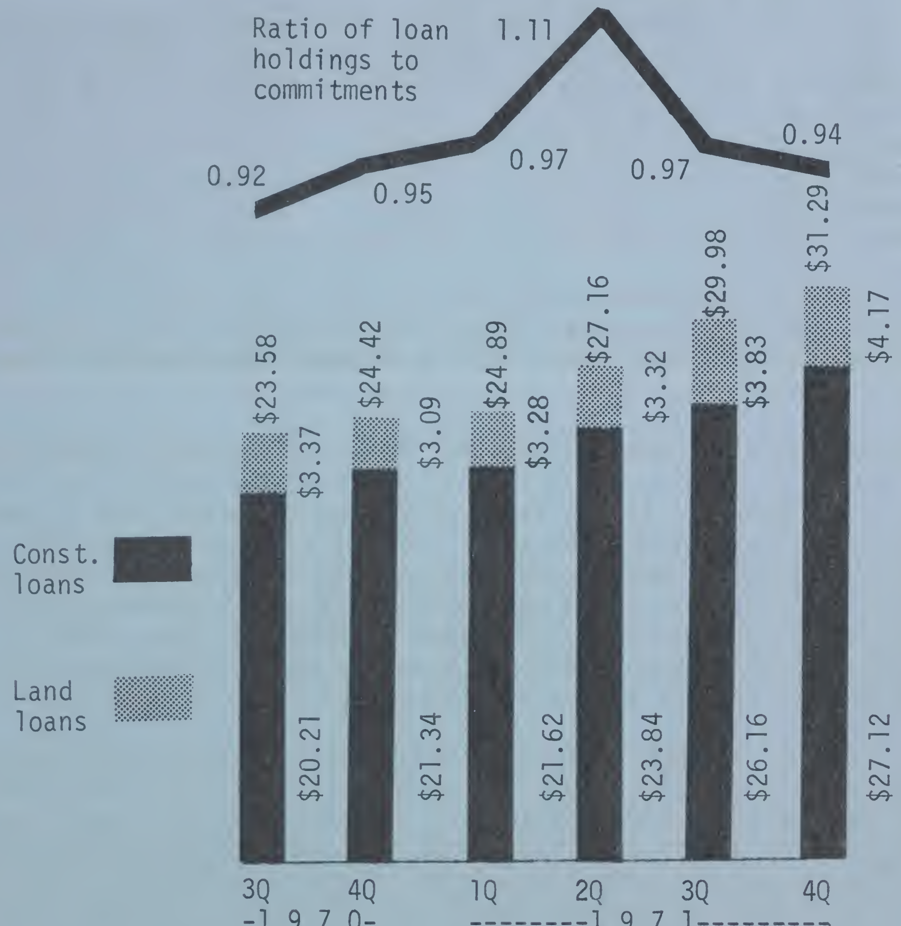


GRAPH II
OUTSTANDING CONSTRUCTION LOAN
COMMITMENTS - BY PROPERTY TYPE
(Quarterly - Billion $)



pacing actual use of funds while a declining ratio points to the reverse, use of funds at a faster pace than new commitments are being generated.

GRAPH III
CONSTRUCTION AND LAND DEVELOPMENT
LOAN HOLDINGS AND RATIO TO COMMITMENTS
(Quarterly--Billion $)



Overall the data provide few surprises in the picture of construction lending by lenders covered in the survey. <u>Commercial banks account for about two-thirds of survey lending,</u> as measured by outstanding commitments, and savings and loan associations add another one-fourth. Together these two institutions account for about 90% of reported construction lending (Graph I).

Commercial banks, as might be expected, nearly doubled their construction loan commitments from $9.8 billion to $17.3 billion between July 1970 and May 1971, the surge corresponding with the general money market ease and sharp reductions in the prime rate. Since then banks have held outstanding commitments at this much higher level, ending last year with $16.6 billion of commitments on their books.

The savings and loans have traced much the same pattern, commitments rising from $3.86 billion in July 1970 to a high of $7.35 billion in July 1971. They ended the year on this same plateau, $6.9 billion.

Construction lending on average appears to be about evenly divided between residential and non-residential loans. Apartment lending loans account for slightly over half of the residential activity, even though they represent a smaller portion of total dollar construction activity. This is expected as apartments typically take longer to build than single-family houses (Graph II).

With growth of mortgage trusts growing relatively slowly in recent months, we now estimate that REITS hold about $4 billion of construction loans and that mortgage bankers hold about an equal amount for their own account. This indicates a total construction loan market of about $35 billion at the end of 1971, a figure that is consistent with our analysis in THE REAL ESTATE TRUSTS: AMERICA'S NEWEST BILLIONAIRES.

Construction loan holdings have been averaging slightly less than 40% of private construction (excluding utilities and non-building construction) for the year and a half covered. Here is the pattern in billions:

	-Private construction-annual rate-			Construction	Constr. loans
	Residential	Non-resid.	Total	loan holdings	% of building
Sept. '70	$30.410	$21.264	$51.674	$20.207	39.1%
Dec. '70	34.030	20.910	54.940	21.335	38.8
Mar. '71	36.605	21.681	58.286	21.616	37.1
June '71	41.138	22.646	63.784	23.836	37.4
Sept. '71	43.785	22.970	66.755	26.156	39.2
Dec. '71	45.488	22.743	68.231	27.122	39.8

Land development loan holdings have risen from $3.37 to $4.17 billion in the year and a half covered. About $3.2 billion of land loans were funded in 1971, indicating that these loans have an average life somewhat longer than normal construction loans, which turn over in about one year.

NEWER MORTGAGE BANKER SPONSORED TRUSTS OFFER STUDY IN CONTRASTS

No group of realty trust shares has received such a mixed reception as those sponsored by mortgage bankers. Mortgage bankers, generally local or regional companies which originate and service mortgage loans for investors in other parts of the country, were among the earliest backers of realty trusts and most of the major mortgage bankers sponsored trusts in 1968 and 1969. When the nation's largest banks and life insurance companies, however, began sponsoring REITs, the mortgage bankers generally retired to the sidelines.

In recent months the smaller mortgage bankers have been sponsoring new trusts with increasing frequency. They have been creating trusts with very special purposes suited to the very special capabilities of the sponsors themselves. The market generally has not become very excited with these newer trusts and many currently sell near book value and offering price. But there is reason to believe that some very interesting opportunities await investors willing to look closely at this group. We present below brief reviews of five trusts sponsored by mortgage bankers with one element in common: share prices are low in relation to book value.

Baird & Warner Mortgage and Realty Investors is sponsored by a diversified Chicago area mortgage banking and real estate firm of the same name. The sponsor currently services over $125 million loans for large life insurance companies, originated $79 million in construction and development loans during 1970, manages over 13,500 rental units plus other commercial property with gross rents of over $23 million and is active in single-family property brokerage.

To take advantage of the investment opportunities flowing from this diversified sponsor, the trust is following a strategy of investing part of its equity--30% is the current goal--in income producing properties while the remainder of equity and borrowed funds are used for short-term investments. The trust at the end of its second quarter in January held $3.6 million of equity investment in addition to $28.2 million of short-term mortgage loans. The equity investments carry $1.68 million of mortgage debt, so that the trust's net investment in these equities is about $1.9 million.

Baird & Warner has proceeded slowly with its equity investments, preferring to seek properties with both good current yield requirements and excellent appreciation potential. The trust bought a 95% interest in a limited partnership owning a 184-unit

apartment project in Glen Ellyn, Ill. and purchased the land beneath a 32-story, 349-unit apartment building overlooking Lincoln Park in Chicago's North Side. Both arrangements give the trust preferred ownership while avoiding depreciation (terms of the apartment partnership give all depreciation to the other partners). Additionally, the trust acquired a small warehouse in Elk Grove, Ill. and a 75,000 sq. ft. office building in Chicago's northwest suburb near O'Hare Field. All properties are rented to satisfactory levels and the package returns the trust about 10.4% on investment. The trust has also agreed to invest $800,000 to buy a major equity position in the proposed Kennelly Square complex of 268 units and 54,000 sq. ft. of commercial space in the Lincoln Park area. This investment should provide a return comparable to other equity investments. By structuring as many deals as possible to avoid depreciation, the trust's equity investments currently penalize reported earnings by only about $0.01 per share quarterly.

Meanwhile the trust has not neglected short-term investments. The construction loan portfolio, all from the Chicago area, grew by $5.6 million in the January quarter and management expects this rate of gain to continue through near-term quarters. The portfolio expansion was financed with bank borrowings which amounted to $6.66 million at January's end. The construction loan portfolio currently has a yield of about 9.4% and this yield might soften a bit in the next quarter or two before beginning to rise.

Commitment growth has been strong, too. At the end of January total commitments were $60.8 million, leaving $32.2 million yet to be funded after the $28.6 million already disbursed. Total commitments increased $19.4 million during the January quarter. Nearly all commitments have been originated by the adviser and on occasion the trust has originated participations for other trusts.

The trust is currently seeking to expand bank lines to the $20 million range to provide funds for anticipated portfolio growth. Because the adviser makes available its property management escrow accounts as compensating balances, the effective cost is essentially ¼% over prime and the trust currently makes about 2%-2½% spread on borrowed funds. The trust earned $0.37 per share in the January quarter and paid $0.34. The projected portfolio growth should be able to sustain gains in both dividends and earnings of about $0.04 per share quarterly through the next two or three quarters. Now selling at slightly less than fully converted book value, the shares are exceptionally well situated.

M&T Mortgage Investors, now nearly half through its second year, has suffered a bit because of the low profile maintained by its sponsor, Mortgage and Trust Co. of Houston. Mortgage & Trust is one of the nation's largest mortgage bankers with $733 million servicing. The only rub is that the company never shows up on nationally published lists of mortgage bankers because management doesn't cooperate with those making such tabulations.

M&T Mortgage Investors is cast in the image of its sponsor. It is unique among mortgage trusts in relying almost entirely upon single-family house loans in Texas for its investments. This is because the sponsor is especially adept at originating and controlling single-family house loans. The sponsor has a network of loan originating offices and works with 102 builders in major Texas cities, with major business being done in Houston, Dallas, Fort Worth and San Antonio. As a result, M&T's average construction loan is $60,000 covering four single-family houses--a small loan size that would result in intolerable administrative costs without the presence of the sponsor. Key to the M&T system is a central computer network which monitors loans on a daily basis and thus spots incipient problems.

Thus M&T is able to roll its loans three times yearly on average. While

its general loan rates of 7% plus 1 point appear low, they translate to a return of 10% on current investments. Gross yield hit a peak of 11.9% in January 1971 before declining to the current yield slightly over 10%. We expect to see some upturn as short-term rates firm.

Bank borrowings have been a bit more expensive than other trusts, ½% over prime. M&T also uses escrow funds of its sponsor as compensating balances so that the trust maintains a spread of about 2 3/4% on borrowings. Leverage is near 2-to-1 now and management believes it can increase that before seeking additional capital.

A negative factor in the trust's capitalization is heavy potential dilution from two classes of warrants, with about 650,000 Series A warrants expiring Aug. 31, 1972 and 751,000 Series B warrants expiring in August 1975. A good share of the Series A warrants are being exercised and full exercise at $10 could add $6.5 million to capital by August. Share earnings of $0.31 in the February quarter (primary) and payout of $0.29 provide a good current yield from the shares at current prices.

Texas First Mortgage Reit is sponsored by another Houston mortgage banker, First Mortgage Co., with $605 million servicing. Texas First Mortgage got off to a relatively slow start after its June 29, 1971 offering and only reached full funding of $18 million at the end of its second quarter in December. The portfolio is about one-third commercial construction loans, one-third residential construction loans and one-third development loans for both subdivisions and office parks. About 70% of loans are in Texas (over half of these in Houston) and the remainder in Atlanta, Phoenix, Washington and other major Southern cities. The adviser has originated about 90% of loans to date and expects to continue to do so through its extensive builder contacts.

Like other Texas trusts, Texas First Mortgage is benefitting from the fact that Texas banks have generally preferred to let mortgage bankers handle the nitty-gritty details of construction lending. Texas First Mortgage has $17 million of bank lines at ¼% over prime and management expects to be near the 1-1 leverage ratio by the end of its first year this June. At Dec. 31 the trust had $10.5 million of unfunded closed loans and another $8 million of unfunded commitments.

Shareholders' equity of $19.5 million provides a comfortable base for growth. The trust earned $0.33 in the December quarter and at current prices near book value is returning slightly over a 7% yield. If the trust's March and June quarters can continue the pattern of about a $0.03 per share growth in earnings and dividends, the shares could move up moderately. But the big-city markets in Texas on which this trust relies are turning extremely competitive and attainment of this goal may take a little bit longer. Warrants to purchase 1 million shares at $20 may also hold back the shares.

First Continental Real Estate Investment Trust (a name which on the surface parrots both the nation's oldest and largest mortgage trusts) actually takes its name from its sponsor, First Continental Mortgage Co., a Houston mortgage banker servicing over $200 million in loans. First Continental made its initial offering Feb. 22 and thus there is no record on which to base investment judgment. However, the offering was notable on two counts: 1) the $11 million financing did not carry warrants, thus avoiding the dilutionary drag present in many other trusts, and 2) the eight trustees purchased 80,000 shares at the public offering price of $10, or a total cash outlay of $800,000. This means that First Continental will be one of the few trusts in which management has a major stake in the future of its shares. Additionally, the parent of the mortgage banker-sponsor bought another 20,000 shares for $200,000 cash and 16,330 shares of the parent, thus giving the trust partial ownership in the adviser's parent company. In a market which has seen some new trust offerings meet weak responses, the First Continental offering was oversubscribed by 10%, giving the trust 1,120,000 shares

outstanding. We will be following this interesting offering in coming issues.

Justice Mortgage Investors is also a recent offering, with shares offered Jan. 13 in units with one warrant at $20. The offering was well received and underwriters exercised a 20% overallotment, resulting in a trust with 1,076,250 shares outstanding and net capital of about $19 million. The adviser and sponsor, Justice Mortgage, is a $500-million servicing mortgage banking company that is beginning to branch outside its Dallas base into surrounding states. Offices in New Orleans and Atlanta are in planning. Justice Mortgage is typical of mortgage bankers which originated strongly for other REITs--it provided $62 million for other REITs in 1971--before deciding to form its own trust. The adviser is the second largest correspondent for John Hancock Life Insurance Co. and thus has early experience in land purchase and leasebacks. The trust has secured $24 million in bank lines, with First National of Dallas the lead lender. These shares too will bear watching.

STATISTICAL PROFILES

Trust	Initial offering Date	Initial offering Price	Book Value	Current price	Current EPS*	Current Div.*	Est. yield	Equity (Mil. $)
M&T Mortgage In.	8/ 4/70	11c	$10.25	$11.00	$1.24	$1.16	10.5%	$ 8.69
Baird & Warner	6/24/71	$200a	19.32	18.63	1.48	1.36	7.3	23.76
Texas First Mtg.	6/29/71	20b	18.51	18.25	1.32	1.32	7.2	19.53
Justice Mtg. In.	1/13/72	20b	18.02	17.75	NR	NR	---	19.39
First Cont. REIT	2/22/72	10	9.16	9.75	NR	NR	---	10.25

a-Units of five shares and $100 of 6 3/4% convertible debentures. b-Units of one share and one warrant. c-Units of one share and two warrants. *Latest quarter annualized. Shareholders' equity includes convertibles.

CONTINENTAL MORTGAGE: POTENTIAL BENEFICIARY OF INTEREST RATE SWING

We first apologize for having misplaced a penny of CMI's dividend in the last statistical issue. Their dividend was actually $0.23, even with the previous quarterly and not down. A year-end $0.07 cleanup was also declared as mentioned. The dividend is as good an indication as we have for March quarter's earnings. They were probably little changed from the $0.25 of the December quarter. Nothing can be said pending the audit. The accrued interest receivable and other asset account and slow loans had not changed much. The longer term outlook was called optimistic. As we see it, firming interest rates will work to CMI's benefit other things as portfolio size being equal. As outlined in RTR-Dec. 13, the $52.3 million fixed debt base averaging 5% worked to disadvantage when short-term rates fell below that in recent months. At 13 5/8-NYSE, the shares are about fairly valued for holding. They have an approximate potential yield of 7.3% on current earning power which appears to be recovering.

FIRST QUARTER OFFERINGS: NEW FINANCINGS SLACKEN SLIGHTLY, SECONDARIES HOLD UP

New trusts raised $192 million in the first quarter of 1972 which was somewhat less than the $246 million quarterly average of 1971. The tabulation below confirms what we felt apparent around mid-1971, new trusts would be more regional in nature and sponsored by less prominent institutions. Additional financing by existing trusts has taken up the slack as $246 million was raised topping the $227 million of the preceeding quarter. Interestingly, the combined total of $438 million raised by all trusts in the first quarter was right in line with total dollars raised in all 1971- $1,576 million. Noteworthy of additional financing by old trusts was the variety and imagination including the introduction of straight debt with warrants.

CAPITAL RAISED BY EXISTING TRUSTS, FIRST QUARTER 1972

Trust	Date	------Unit-------- Sh/Wt/Deb #	Price	---Proceeds (Mil $)--- Equity	Conv. Debt.	Total
Alison Mtg. Inv. Tr.	1/14	0/20/CV	1000	---	20.0	20.0
BT Mortgage Inv.	1/11	0/30/ST	1000	---	20.0	20.0
Heitman Mtg. Inv.	1/19	0/0 /CV	1000	---	30.0	30.0
Amer.Fletcher M.I.	1/26	1/	27.75	21.1	---	21.1
Saul (B.F.) REIT	2/2	0/0 /CV	1000	---	35.0	35.0
Tri-South Mtg. Inv.	2/8	0/0 /CV	1000	---	25.0	25.0
Atico Mortgage Inv.	2/10	0/44/ST*	1000	---	20.0	20.0
Cousins Mtg. and Eq.	3/1	0/25/ST	1000	---	30.0	30.0
North Amer.Mtg.In.	3/21	0/24/ST	1000	---	30.0	30.0
Old Stone Mtg.and Rl.	3/23	0/40/CV	1000	---	15.0	15.0
TOTALS				$21.1	$225.0	$246.1

#-All units were $1,000, CV-convertible, ST-straight debentures. *-These debentures usable at face value toward exercise of warrants.

A rights offering for $10 million in stock by Palomar Mortgage became effective March 20 and expired April 7. This will be included in second quarter totals.

CAPITAL RAISED BY TRUSTS - FIRST QUARTER 1972

Initial Offerings

Trust	Date	Type*	Sh/Wt	Price	Thou. Shs.	Proceeds (Mil.$) Equity	Underwriter
Central Mtg.&Rlt.	3/28	ST	1/1	20	750	15.0	Stern Bros.
Manager: 928 Grand Ave. Kansas City, Mo 64142, 816/421-6400							
Citizens Growth Pr.	1/20	E	1/1	20	800	16.0	Prescott,Merrill Turben
600 Public Square Bldg. Cleveland, O. 44113, 216/692-1800							
First Cont'l.	2/22	ST	1/	10	1,000	11.0	L.M. Rosenthal
3693 Southwest Freeway Houston, Texas 77027, 713/626-3870							
Hospital Mtg. Gp.	2/17	LT	1/1	25	1,170	29.3	Shearson, Hammill
Advisor: 1175 N.E. 125th St. N. Miami, Fla. 33161, 305/891-7602							
IDS Realty Tr.	1/28	ST	1/½	25	2,400	60.0	Lehman Bros.
1050 Roanoke Bldg. Minneapolis,Minn.55402, 612/372-3186							
Justice Mtg. Inv.	1/13	ST	1/1	20	1,050	21.0	Edwards & Hanly
1400 Main St. Dallas, Texas 75202, 214/748-8111							
Miller (Hen.S.) Rl.	2/9	E	1/	20	500	10.0	Rauscher Pierce
2500 One Main Place Dallas, Texas 75250, 214/748-9171							
Northwestern Fin.	1/18	LT	1/1	20	1,500	30.0	Shields
Adviser: 500 East Morehead St. Charlotte, N.C. 29201, 704/375-8484							
TOTAL						$192.3	

*E-Equity, ST-Short-term, LT-Long term.

Errata: Larwin Mortgage's annualized earnings in last issue's statistical section should have been $2.56, not $2.76 as stated.

Written as of noon, Thursday, April 6.